



Transforming Financing Landscapes: Enabling Sustainable Infrastructure Development

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The global demand for infrastructure development has reached unprecedented levels, with every country recognising its tremendous potential for economic growth and societal advancement. However, the conventional approach to infrastructure development has come at a significant cost in terms of carbon emissions and environmental impacts. To forge a sustainable future, **it is crucial to transform the financing landscapes that enable the development of sustainable infrastructure.**

Infrastructure projects have gained considerable momentum worldwide. The Global North is seeking to modernise existing infrastructure and adapt to evolving industries, while the Global South is focussing on bridging gaps in basic services and driving economic growth.

However, it is essential to acknowledge the environmental consequences associated with these projects. Traditional infrastructure has been a major contributor to carbon emissions, exacerbating climate change and environmental degradation. The construction industry alone accounts for a staggering 39% of energy-related carbon emissions. This calls for a transition towards sustainable infrastructure solutions that minimise carbon footprints, promote renewable energy and prioritise ecological conservation.

Redirecting financial resources from the global economy to achieve net zero is indispensable. This holds particularly true in emerging markets due to their inherent socioeconomic difficulties. Adequate financing is pivotal for subnational governments, as they face challenges in funding sustainable investments and might experience significant strain on their annual budgets. To achieve the desired sustainability results, there is a pressing need for investors and governments to enhance the alignment of their interests and collaborate effectively.

Emerging markets focus

Emerging market economies face long-term and complex risks that pose challenges for investors in assessing and managing these risks effectively. **The estimated annual investment gap for infrastructure assets in these economies amounts to a staggering \$1.3 trillion.** This highlights the need to create an environment where investors can make informed decisions based on relevant information and data.

Subnational governments rely heavily on debt instruments, such as loans and bonds, as their primary means to mobilise financial resources for infrastructure development. These instruments enable governments to access financing for sustainable infrastructure projects and play a key role in bridging the financing gap.

Additionally, the private sector can serve as another tool to use for financing. **Public–private partnerships provide a second path for financing sustainable infrastructure, primarily through equity investments.** By capitalising on the expertise and resources of the private sector, governments can attract additional funding and promote the efficient implementation of sustainable infrastructure projects.

Analysing the cost of capital

To understand the factors contributing to the **financing gap** in emerging markets, an analysis of **capital structure** costs associated with infrastructure projects is central. The capital structure of an infrastructure project refers to the way the project is financed and the **combination of debt and equity** used to fund its development and operations.

Debt financing allows project sponsors to leverage their investment by **borrowing money** from banks, financial institutions or capital markets. This debt is usually long-term and repaid over an extended period through the **project's cash flows.**

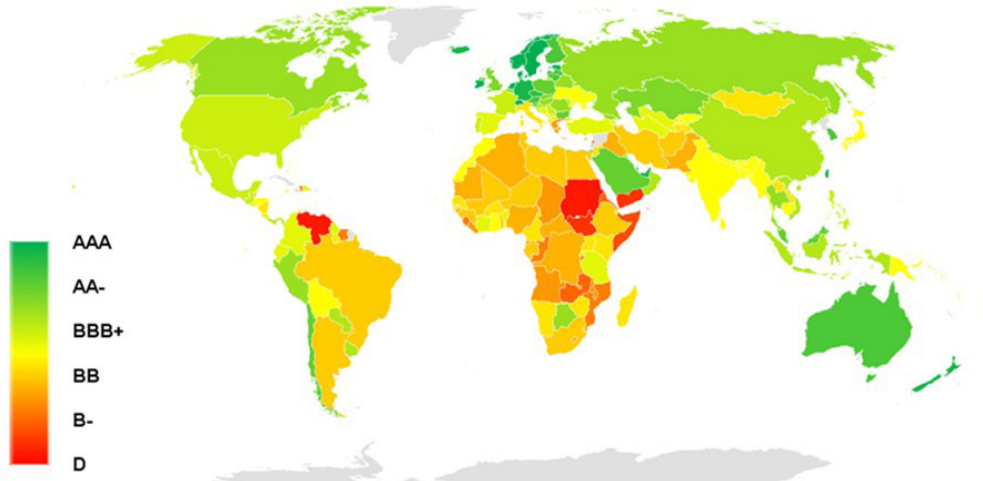
Equity financing is another component of the capital structure and represents the **ownership** stake in the project. Equity investors contribute funds to the project in exchange for a share of its profits and control over decision-making. They bear the risk of the project's performance and receive returns in the form of **dividends or capital gains.**



Cost of Debt

In examining the various components of capital structure costs, our focus will primarily be on the expenses associated with **debt in emerging markets**. Sovereign credit ratings assess the **creditworthiness** of a country and its ability to repay its debt obligations. Ratings agencies evaluate factors such as **economic stability, fiscal discipline, political stability, institutional quality** and the **effectiveness of monetary policies** to determine these ratings.

Figure 1: Comparison of sovereign credit score by rating agencies



Countries in the Global North tend to have **higher sovereign credit** ratings than those in the Global South. The differences in sovereign credit ratings have important implications for these countries. Higher credit ratings for Northern countries can lead to **lower borrowing costs**, increased **investor confidence** and greater **access to international capital markets**. This enables these countries to finance their infrastructure projects and public services more easily and at favorable interest rates.

By contrast, **lower credit ratings** for **emerging market** countries can result in **higher borrowing costs**, **limited access to financing** and **increased vulnerability** to external shocks. This can hinder their ability to invest in infrastructure, social programmes and economic development, potentially slowing down their progress and limiting their capacity for growth. These challenges are often rooted in factors such as **weaker institutional frameworks, elevated debt levels** and **less established financial markets**.

Cost of Equity

Similarly, the **cost of equity is elevated in these markets** due to investors perceiving a **higher risk**. The higher cost of equity in emerging markets can be linked to the concept of **systematic risk**, which measures the **sensitivity of an investment to market movements**.

As mentioned earlier, emerging markets are often characterised by higher political and economic risks, operational challenges and regulatory uncertainties. These factors contribute to the **higher volatility** and fluctuations in the market. Investors regard these risks as more significant, necessitating a higher cost of equity to offset potential losses and disruptions; in other words, investors require the additional return for **assuming market risk**.

How do we reduce the cost of capital?

A comprehensive understanding of the factors contributing to the financing gap allows us to identify approaches aimed at reducing the cost of capital.

One effective solution for developing nations is the use of **sustainable financial debt products**, which enable funding for sustainable infrastructure projects, while simultaneously **reducing debt expenses**. These financial instruments attract investments from environmentally **conscious investors** who prioritise environmental, social and governance (ESG) factors. This not only provides access to capital but also facilitates cost savings through **reduced interest rates** or **improved project performance**, promoting long-term sustainable development.



How do we reduce the cost of capital? (continued)

Among the tools most employed in this context are green and sustainable bonds, as well as green and sustainability-linked loans:

- **Green bonds** are debt instruments issued by governments, municipalities or corporations with the specific purpose of financing environmentally friendly initiatives. The funds raised from these bonds are exclusively **allocated to green projects**, such as renewable energy initiatives, energy efficiency enhancements, sustainable agriculture projects or clean water programmes. By directing capital towards these environmentally beneficial projects, green bonds contribute to the development of sustainable infrastructure.
- **Sustainability-linked loans** are structured as credit facilities in which the interest rates are linked to predetermined **sustainability performance targets**. If the borrower successfully achieves the established sustainability goals, the interest rates on the loan are reduced, resulting in cost savings. This incentivises borrowers to actively pursue and achieve sustainability objectives, leading to positive environmental and social outcomes.

The **use of sustainable financial debt products** not only addresses the financing needs of infrastructure projects but also aligns with global sustainability goals. By promoting the flow of capital towards environmentally friendly initiatives, these financial instruments **accelerate the transition** to a more sustainable future. They **attract investments** from ESG-focussed investors and create opportunities for **collaboration** between **governments, private sector** entities and other stakeholders. Overall, the adoption of sustainable financial debt products supports the development of sustainable infrastructure, while fostering economic growth and environmental stewardship.

There are highly effective strategies available to **mitigate the cost associated with equity**, thereby creating greater opportunities for the successful execution of sustainable infrastructure projects. **Regulatory incentives** and subsidies play a crucial role in this objective. Governments can offer **tax credits**, exemptions or reduced tax rates as a means to **incentivise private equity firms** and institutional investors to **invest in sustainable infrastructure**. By implementing regulations that promote sustainable financing and establishing a standardised taxonomy, the perceived risk for investors can be significantly reduced. Managing the cost of equity primarily aims to **minimise risk** and **assure investors**. **Partnerships and co-investments** between public and private entities are highly effective in reducing the cost of equity. These collaborations **share risks and costs**, making it more attractive for investors to participate.

Guaranteeing reliable revenue streams, such as through power purchase agreements and feed-in tariffs, instils investor confidence by providing predictability and stability. **Effectively managing risks** associated with technology, regulations and project execution is imperative to creating a favourable investment environment.

Emerging countries are making **significant progress** in regulating sustainable finance, **aligning financial and sustainable development goals**. Implementing **regulations** and **frameworks** supports sustainable finance **initiatives**, driving down the cost of capital for sustainable infrastructure projects.

By implementing regulatory incentives, encouraging partnerships, and providing reliable revenue streams, countries can attract greater investment in sustainable infrastructure and reduce the cost of equity. These measures **facilitate sustainability goals while contributing to economic growth, job creation and environmental stewardship**.

Figure 2: GCC countries paving the way to sustainable finance





Achieving a sustainable future hinges upon our ability to revolutionise financial landscapes and facilitate the growth of sustainable infrastructure. Though we face formidable challenges, ranging from carbon emissions in the construction industry to the financing gap in emerging markets, they are not insurmountable. As we gear up for **COP 28**, it is essential to be inspired by the immense potential offered by sustainable investments. By **harmonising financial systems** with environmental, social and governance objectives, we can establish an atmosphere where investors can make **well-informed choices**, channelling their resources into **projects that yield not only financial gains but also positive environmental and social impacts**.

The pursuit of sustainable infrastructure necessitates the **collaborative efforts** of all stakeholders: **governments, investors, project developers** and **communities** alike. By **diminishing perceived risks** and ensuring **reliable income streams**, we can cultivate an investment environment that is conducive to progress. Through fostering **trust, stability** and **predictability**, we can minimise the cost of equity and create a space in which sustainable infrastructure projects can flourish. **As we envision a net-zero future, it is imperative that we seize the opportunities presented by sustainable finance and sustainable infrastructure.**



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